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Deductibility of Rental Payments Where Reversion Is Retained In Gift, Leaseback Arrangement

C. James Mathews, 61 T.C. 12 (1973)

For the high-income bracket taxpayer seeking to reduce his tax burden, a gift and leaseback can be a valuable device for reallocating income within the family.[1] To utilize this tax-saving tool,[2] the taxpayer transfers business property to a trustee in short-term trust for his dependents or other beneficiaries, taking care that the trust income is not used to discharge any legal obligation of the taxpayer.[3] By a simultaneous agreement, the trustee leases the property back to the taxpayer for use in his business. The taxpayer then may take a business expenses deduction under section 162(a)(3) of the Internal Revenue Code ("Code") for the rental payments made to the trustee, while the rental income is split among the lower income brackets of the beneficiaries. When the trust terminates, the property may either be conveyed to the beneficiaries or to a third party, or, as occurred in *C. James Mathews*,[4] revert to the taxpayer. This note will consider whether

1. For an illustration of possible savings offered by a gift and leaseback, see CCH 1974 STAND. FED. TAX REP. ¶ 259.12. Advantages of the gift and leaseback include the opportunity to use otherwise "locked-in" assets for tax savings with a minimal disruption of business relationships. For the professional with few capital assets, the gift and leaseback may be a practical method to split income. *See* Simmons, *New Developments in the "Gift and Leaseback" in Tax Planning for the Professional*, 51 TAXES 654 (1973).
2. Closely related forms of leaseback transactions not discussed in this Note include a transfer of property by absolute gift and a transfer of cash to a trustee who purchases the property to be leased to the taxpayer. *See, e.g.*, White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951); Helen C. Brown, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). The taxpayer may also use a sale and leaseback. *See, e.g.*, Albert T. Felix, 21 T.C. 794 (1954).
3. Any part of the trust income actually used to discharge the taxpayer's legal obligations would be taxed as income to the taxpayer. INT. REV. CODE OF 1954, § 677.
4. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7 (1973). Appeal filed by the Internal Revenue Service, P-H 1974 FED. TAXES ¶ 60,112, at 60,168.

the taxpayer who retains a reversion may be denied a deduction for the rental payments made during the term of the trust.

Not surprisingly, the gift and leaseback arrangement has met substantial resistance from the Internal Revenue Service[5] and has been the subject of considerable litigation,[6] the results of which have created confusion about what the taxpayer must do to utilize this type of trust.[7] The problem arises because no provision of the Code speaks specifically to the gift and leaseback situation. Sections 671 to 678, the so-called Clifford provisions, determine only when the grantor of a short-term trust will be taxed on the trust income.[8] Therefore, to determine when the taxpayer may take a deduction for rents paid to the trustee, the courts have had to proceed on a case by case basis under section 162(a)(3).

Section 162 of the Code provides:

> (a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
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> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

The bulk of gift and leaseback decisions has focused on whether rents paid to the trustee were actually "necessary" and "required."[9] For rents to qualify, the courts have usually required the taxpayer to show one or more of the following: relinquishment by the taxpayer of effective control of the property to the trustee;[10] indepen-

5. In 1973, the Internal Revenue Service listed the gift and leaseback as a "prime issue" to be litigated rather than settled. INT. REV. SERVICE MANUAL, MT-1277-6 (Jan. 1, 1973).
6. For a general review of earlier gift and leaseback litigation, see Oliver, *Income Tax Aspects of Gifts and Leasebacks of Business Property in Trust*, 51 CORNELL L.Q. 21, 25-30 (1965). For later cases, see Fiore, *New Possibilities and Old Pitfalls in Irrevocable Living Trusts*, 111 TRUSTS & ESTATES 8 (1972).
7. *See* notes 9-14 and accompanying text *infra*.
8. INT. REV. CODE OF 1954, §§ 671-78.
9. *See* Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972); Audano v. United States, 428 F.2d 251 (5th Cir. 1970); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965); Brown v. Commissioner, 180 F.2d 926 (3d Cir. 1950); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); Duffy v. United States, 343 F. Supp. 4 (S.D. Ohio 1972); Chace v. United States, 303 F. Supp. 513 (M.D. Fla. 1969).
10. *See, e.g.*, Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972); Van Zandt v. Commissioner, 341 F.2d 410 (5th Cir. 1965); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); Chace v. United States, 303

dence of the trustee;[11] reasonableness of rental payments;[12] observation of certain formalities;[13] and a discernible business purpose for the transactions.[14] But the question of whether the taxpayer had a disqualifying "equity" interest as provided in section 162 (a) (3) has been litigated less frequently. Obviously, the taxpayer who has completely divested himself of the trust property by giving the remainder interest to a third party has no "equity." When the taxpayer has retained a reversion in himself, however, there has been uncertainty whether such an interest was a prohibited "equity" sufficient in itself to deny the rental deduction.[15] In *C.*

F. Supp. 513 (M.D. Fla. 1969); Jack Wiles, 59 T.C. 289 (1972); Sidney W. Penn, 51 T.C. 144 (1968).

11. *See* Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) (taxpayer as a court appointed guardian deemed independent); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965) (taxpayer acting as trustee denied a rent deduction); Duffy v. United States, 343 F. Supp. 4 (S.D. Ohio 1972) (bank held independent trustee); Robert F. Zumstein, 32 CCH TAX CT. MEM. 198 (1973) (lack of independence of trustee who failed to enforce lease requirements); Jack Wiles, 59 T.C. 289 (1972) (taxpayer acting as trustee denied rental deduction); Alden B. Oakes, 44 T.C. 524 (1965) (bank trustee held independent).
12. *See* Audano v. United States, 428 F.2d 251 (5th Cir. 1970); Brown v. Commissioner, 180 F.2d 926 (3d Cir. 1950); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948). Rent can be a factor in disallowing deductions whether unreasonably low, *see* Chace v. United States, 303 F. Supp. 513 (M.D. Fla. 1969), or unreasonably high, *see* Kirschenmann v. United States, 225 F.2d 69 (9th Cir. 1955).
13. *See, e.g.*, Audano v. United States, 428 F.2d 251 (5th Cir. 1970) (lack of written lease); Brown v. Commissioner, 180 F.2d 926 (3d Cir. 1950) (valid trust instrument, valid lease); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948) (valid trust instrument, valid lease); Duffy v. United States, 343 F. Supp. 4 (S.D. Ohio 1972) (valid deed, written lease); Jack Wiles, 59 T.C. 289 (1972) (deduction denied where rent arrangement was informal); Sidney W. Penn, 51 T.C. 144 (1968) (deduction denied, no written lease).
14. Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965). *But see* Alden B. Oakes, 44 T.C. 524 (1965). Each of the factors examined by the courts naturally overlaps. Discussion of the courts' examination of gift and leasebacks may be found in Note, *Tax Consequences of an Intrafamily Transfer of Business Property Into Trust For Dependents With a Leaseback By the Grantor's Business*, 73 COLUM. L. REV. 1420 (1973); Note, *Gift and Leaseback—Tax Planning In the Shadows of Assignment of Income and Business Purpose*, 62 GEO. L.J. 209 (1973); *Gift and Leaseback: A Continuing Tax Controversy*, 4 LOYOLA U.L.J. 371 (1973).
15. *See* Thomas B. Gibbons, 25 Am. Fed. Tax R.2d 1332 (D.N.M. 1970) (deduction disallowed because taxpayer's reversionary interest was held to be a prohibited equity); Chace v. United States, 303 F. Supp. 513 (M.D. Fla. 1969) (deduction disallowed; opinion open to the interpretation that a reversionary interest is an "equity"); Hall v. United States, 208 F. Supp. 584 (N.D.N.Y. 1962) (deduction disallowed; alternate holding that a reversion is an "equity"); Alden B. Oakes, 44

James Mathews,[16] this previously subordinate issue became central, and in a a somewhat unexpected decision, the Tax Court held that a mere reversion, not derived from the lease or the lessor, which will become possessory only after the lease expires, is not a disqualifying "equity" interest under section 162(a)(3).

The taxpayer in *Mathews* was a funeral director in St. Petersburg, Florida, who, with his wife, owned the property on which the funeral home was located. In 1961, the petitioner and his wife transferred this property by warranty deed to their attorney in irrevocable trust for their children for ten years and one day, at which time the trust corpus was to revert to the grantors or their estates. By a simultaneous, prearranged transaction, the petitioner leased the property from the trustee and continued to operate the premises as a funeral home.[17] Under a subsequent lease, the taxpayer had the option to renew his lease from year to year under terms agreeable to both parties. The commissioner disallowed the taxpayer's rental deductions for 1964 and 1965, and for the period from January 1 to May 23, 1966, at which time the taxpayer and his wife had relinquished their reversionary interests in the property. The court found that under the particular facts of the case, the taxpayer had met all the requirements set out in prior cases for showing the business necessity of the rental payment.[18] In so finding, the court was squarely faced with the issue of whether Mathews' reversion came within the equity provision of section 162(a)(3).

T.C. 524 (1965) (dictum, a reversion is an "equity"). Even in cases where the equity provision had not been specifically invoked, a taxpayer with a reversionary interest had never been granted a deduction. *See, e.g.*, Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965). The consensus of tax planning advice at the time of *Mathews* was that a reversionary interest in the taxpayer would be fatal to his gift and leaseback plan. *See* Fiore, *supra* note 6; Simmons, *supra* note 1; *Estate Planning Through Family Bargaining*, 8 REAL PROPERTY, PROBATE & TRUSTS J. 223, 238 (Summer 1973).

16. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7 (1973).
17. The terms of the first lease were not discussed by the court.
18. These requirements as seen by the Tax Court were three:
    1. The grantor must not retain " 'substantially the same control over the property that he had before' he made the gift." P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7, -10 (1973), *quoting* Sidney W. Penn, 51 T.L. 144, 150 (1968). This was interpreted by the court to mean in essence that the property had been transferred to an "independent" trustee having the right and opportunity to negotiate the lease and who acts primarily on behalf of the beneficiaries. Mathews' attorney was found to be such an "independent" trustee. *Id.* at 61-11.
    2. The rent must be reasonable and paid under a written lease. *Id.*

Defining "equity" as used in section 162(a)(3) was no simple task. The prohibition of rental deductions for property in which the lessee has taken or is taking title or in which he has an "equity" interest first appeared in the Code in 1916.[19] It was apparently intended to close a tax loophole which had allowed mortgagors to take "rent" deductions on the grounds that mortgage payments were necessary for "continued use and possession" of the property.[20] The language adopted by Congress is obviously much broader than the situation which is said to have prompted it.[21] Yet "equity" is not defined by the statute, nor has it ever been clarified by regulation.

In general legal parlance, "equity" would be defined as "a right of redemption, a reversionary interest, a right to specific performance, or in general any right respecting property which traditionally would have been enforceable by means of an equitable remedy."[22] The Tax Court in dictum in *Alden B. Oakes* had previously cited this definition in support of its opinion that a reversion in a gift and leaseback would *per se* be a disqualifying "equity" interest. The *Mathews* court, however, followed the lead of some commentators[23] in noting that this definition, if taken literally, would lead to anomalous tax results.[24] It would of necessity preclude deductions by lessees in a wide variety of common business rental situations. For example, a remainderman renting from a life tenant, or a tenant in common renting his co-tenant's interest to secure sole use of the property, would each have a prohibited "equity" within this broad meaning.[25] Presuming that Congress

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3. The leaseback must have a bona fide business purpose. The court found that Mathews had satisfied this requirement in that he needed the building for his funeral business and had paid a reasonable rent as a condition to the continued use of the property. *Id.*

19. Revenue Act of 1916, § 12(a) (1st), 39 STAT. 756, 767 (1916).
20. 4 A. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.108 (rev. ed. 1972); Froelich, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements*, 52 CALIF. L. REV. 956, 975 n.74 (1964).
21. No explanation for the particular wording is offered by either the Senate or House Report. S. REP. No. 793, 64th Cong., 1st Sess. (1916); H.R. REP. No. 922, 64th Cong., 1st Sess. (1916).
22. Alden B. Oakes, 44 T.C. 524, 531 (1965); *see* 61 T.C. 12, P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7, -11 (1973).
23. *See* Froelich, *supra* note 20, at 974-75.
24. Indeed, as the court notes, applied in its most literal sense, no lessee would ever be entitled to a deduction, as every lessee has the right to specific performance of terms of the lease. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7, -12 (1973).
25. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7, -12 (1973). *See* Froelich, *supra* note 20, at 976.

could not have intended such sweeping tax consequences, the Tax Court sought a narrower definition of "equity."

The court relied primarily on an analogy to the lease-purchase situation, in which the lessee pays a specified periodic "rent" and later acquires title upon payment of an option price. Under such an arrangement, the lessee has been held to have a disqualifying "equity" if, in light of all the circumstances existing at the time of the contract, it appears that the lessee's payments have been purchasing not only the use and possession of the property but an ownership interest as well.[26] These cases have thus interpreted "equity" in its business sense to mean a capital investment by one who has not yet acquired full ownership.[27]

The *Mathews* court agreed that the "equity" disqualification could fairly be applied to the lease-purchase case, reasoning that there is no injustice in denying a deduction for a payment which is not for the temporary use of land, but is actually adding to an ownership interest. When the deduction is denied, the payment is not lost to the taxpayer; rather it can be capitalized to reflect fairly the sale transaction which has actually occurred. On the other hand, rental payments made by a gift and leaseback taxpayer with a reversionary interest do not enlarge the taxpayer's ownership interest. If denied as deductions, they could not be capitalized and would be lost entirely to the taxpayer. Likewise, a reversioner subleasing from the holder of a ninety-nine year lease and the owner of an undivided interest renting from his co-owner do not increase their ownership interests through their rental payments. Viewing these situations as indistinguishable from each other, and deeming it unfair to disallow the deduction in every such case, the court determined that it could not disallow the deduction in the gift and leaseback case. The conclusion of the court was that a disqualifying "equity" does not include a lessee's ownership rights held concurrently with, but not derived from, the lessor's property rights or enlarged through the rental payments.[28]

While the court's opinion was based on unelaborated concepts of "fairness," its ultimate finding that a reversionary interest is not *per se* an "equity" within section 162(a)(3) appears justified. The objection might be raised that the court's decision places the

26. *E.g.*, M & W Gear Co. v. Commissioner, 446 F.2d 841 (7th Cir. 1971), *modifying* 54 T.C. 385 (1970); Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952); Chicago Stoker Corp., 14 T.C. 441 (1950); Judson Mills, 11 T.C. 25 (1948).

27. *See* Johnson, *Lessee Improvements to Leased Property and Option to Purchase*, N.Y.U. 12TH INST. ON FED. TAX 75, 89-90 (1954).

28. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7, -13 (1973).

taxpayer on par with the "ordinary" lessee, when in fact the taxpayer receives benefits which the "ordinary" lessee does not. Each year that passes, the taxpayer's reversionary interest becomes proportionately more valuable to the taxpayer until the end of the trust term, when, of course, one hundred per cent of its value is again his. Furthermore, a part of the rental payments may be used for general upkeep[29] or to maintain insurance on property in which the taxpayer will soon have a full interest. In addition, at the end of the term, the taxpayer will probably have the added benefit of substantially appreciated property. It could be argued that this accumulaton of benefits represents a present "equity" which should operate to disallow the taxpayer's deduction.[30]

The Tax Court made no mention of the taxpayer's position relative to the "ordinary" lessee. Nevertheless, the same considerations which led the court to hold that a reversion viewed as a future interest is not a disqualifying "equity" apply to the reversion viewed as a present interest. The court noted that in the lease-purchase situation any benefits associated with an ownership interest in the property derive from and continue to depend upon the taxpayer's "rental" payments. The court contrasted this with the taxpayer in the gift and leaseback situation who does not increase his ownership interest through his payments.[31] Recognizing

29. If a portion of the trust income is used to make extraordinary improvements, it could be taxed as income to the taxpayer under § 677 (a) of the Code:

> GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
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> (2) held or accumulated for future distribution to the grantor or the grantor's spouse;
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> . . . .

30. *See* Note, *Gift and Leaseback—Tax Planning In the Shadows of Assignment of Income and Business Purpose*, 62 GEO. L.J. 209, 225 n.114 (1973).

31. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7, -13 (1973). Mathews' funeral home was apparently subject to a mortgage. The record did not indicate whether the trustee was making principal payments. Since the Commissioner did not contend that Mathews was building up "equity" through mortgage payments by the trustee, the court did not speculate whether such an arrangement would constitute an "equity" under § 162(a)(3). *Id.* at 61-11. The taxpayer whose trustee makes mortgage payments might also be subject to taxation on the amounts so applied as income under § 677(a) of the Code. *See* note 33 *infra*. For a discussion of the possible tax consequences of a short-term trust assuming the grantor's mortgage payments, see *Tax Consequences of Gifts of Encumbered Property In Trust*, 8 REAL PROPERTY, PROBATE & TRUSTS J. 371 (Fall 1973).

a present "equity" in the taxpayer would not have altered this comparison. The benefits the taxpayer receives by virtue of his reversionary interest accrue to him regardless of whether he makes rental payments to the trustee. Clearly, had the taxpayer placed his property in trust and proceeded to lease equivalent property for his business from a third party, the same benefits associated with his reversionary interest would have inured to him. When the taxpayer rents the trust property instead, his rental payments secure no more benefits than he already had. He cannot be said to be increasing his ownership interest through his payments to the trustee. Likewise, there remains the impracticality of distinguishing the gift and leaseback lessee from other lessees with remainder or reversionary interests. These other lessees have a similar accrual of benefits independent of the rentals paid and would also be denied a deduction even though they have received no particular tax benefit from their rental arrangements.[32]

Assuming that the *Mathews* approach to the equity provision is accepted by other courts, the taxpayer ought to be aware that retaining a reversionary interest may still be a risky tax maneuver. The gift and leaseback plan as a whole must provide that effective control of the trust property has been relinquished to the trustee. The *Mathews'* inquiry into control was quite cursory and apparently did not include the taxpayer's reversion as a factor to be considered.[33] Other courts may not be as willing, however, to pass over the practical significance of the reversion. When the taxpayer retains a reversion, there is one less change in his position to which the court may look in support of the *bona fides* of the transaction. Given the short duration of the trust, and the possible close relationship of the taxpayer, trustee and beneficiaries, a court might find, as a practical matter, when the taxpayer has become a major beneficiary by retaining a reversionary interest, the property has been managed for the taxpayer in exactly the same way he would have managed it for himself. On this basis, the court could hold that the entire transaction lacked "economic reality" and was a nullity for tax purposes.[34] Alternatively, the

32. For example, the rents made by a remainderman to a life tenant may be applied toward repairs and insurance, while the property may appreciate in value during the rental period. For tax purposes a line might be drawn between a lessee whose future interest is voluntarily created by the lessee himself, and one whose interest derives from some other source. Under such a rule, however, a taxpayer who conveyed a life estate while retaining a reversion would still be precluded from deducting any rental payments made to the life tenant.
33. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7, -11 (1973).
34. *See* Irvine K. Furman, 45 T.C. 360, *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967).

court could hold that the taxpayer with a reversion, as the effective owner of the trust property, does not need to make rental payments, and thereby fails to meet the "ordinary and necessary" requirement of section 162(a).[35]

CONCLUSION

The Tax Court in *C. James Mathews*[36] became the first court to examine in detail whether a reversion is an "equity" under section 162(a)(3) of the Code, sufficient in itself to disallow rental payments made in conjunction with a gift and leaseback. Other courts may approve its holding that such a reversion is not a disqualifying "equity," if they foresee undesirable effects on other lessees with reversions or remainders should the gift and leaseback lessee be denied a deduction. At the same time, the taxpayer who retains a reversion may be inviting a court to conclude that his rental payments are not "ordinary and necessary" or that his trust transaction as a whole is an economic nullity which may not be recognized for tax purposes. Because of these uncertainties, the taxpayer setting up a gift and leaseback would be best advised to avoid creating a reversion whenever possible.

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35. *See* Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965).
36. P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-7 (1973).